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SENSITIVE

EB/ESC/IEC FOR SGALLOGLY, MMCMANUS,JIZZO
WHA FOR WHA/BSC AND WHA/EPSC
E FOR THOMAS PIERCE
PASS NSC FOR JOSE CARDENAS
PASS FED BOARD OF GOVERNORS FOR PATRICE ROBITAILLE
PASS USTR FOR SUE CRONIN AND MARY SULLIVAN
TREASURY FOR ALICE FAIBISHENKO
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER
US SOUTHCOM FOR POLAD

E.O. 12958: N/A
TAGS: ENRG EPET ECON ETRD AR
SUBJECT: AMBASSADOR HOSTS ELECTRICITY, GAS SECTOR U.S. INVESTOR
ROUNDTABLE

Ref: (A) Buenos Aires 2598
(B) Buenos Aires 2594
(C) Buenos Aires 2683

Summary

¶1. (SBU) Country managers of U.S. players in Argentina's electricity and natural gas sectors met with Ambassador to review constraints imposed by GoA regulations, uncertain natural gas supplies for generation, and frozen retail electricity and gas tariffs. Participants representing AES, CMS, Duke, Eton Park and E-On detailed company-specific stories about how GoA regulations and price controls imposed after the 2001 economic crisis had impacted their operations and strategic approach to the Argentine energy market. They complained about unmet GoA contractual obligations (including late capacity payments electricity generators) and unmet GoA promises (including delays of promised 2006 tariff review until after October 2007 elections).

¶2. (SBU) All participants agreed that electricity and gas regulatory authorities established during Argentina's 1990s privatization process were no longer independent. They saw little in the way of long term vision in the GoA's energy policy mix, but rather a short term focus on maintaining below market consumer prices in this pre-election year. They doubted that the GoA would - as it has promised - move to a less regulated electricity and gas pricing model by 2008. Finally, most participants argued that, while they could adapt their operating and investment strategies to a suboptimal but stable policy mix, the GoA's penchant for changing the rules of the energy sector game preemptively and without consultation made it difficult for them to justify investments in expanded energy capacity the Argentine market needs. Participants accepted Ambassador's offer to set up a roundtable meeting with

Planning Minister De Vido to offer a forum for the GoA to address these issues. END SUMMARY.

Complaints: Politicized Regulation, Lack of GoA Vision

¶3. (SBU) In the second in a series of sector-specific roundtables with U.S. investors (the first was held with upstream and downstream hydrocarbon investors - see Ref A), Amb met December 13 with representatives of U.S. electricity generation, transmission, and distribution as well as natural gas pipeline and distribution players. Attendees included AES Country Manger Eduardo Dutrey; CMS CEO Bernardo Velar de Irigoyen; Duke Energy Country Manager Guillermo Fiad; E-On USA Country Manager Enrique Flaiban; and Eton Park consultant Federico Ravazzani. Participants reviewed operating constraints imposed by the GoA's energy sector regulations, uncertain natural gas supplies for generation, frozen retail electricity and gas tariffs and discussed how these have affected their business strategy and investment decisions.

¶4. (SBU) Participants detailed company-specific stories about how GoA regulations and price controls imposed following the 2001 economic crisis, had impacted their profitability, operational viability and strategic approach to the Argentine energy market. Hydro and thermal electricity generators (AES, CMS and Duke) complained of GoA electricity pricing formulas for spot market sales that are roughly 65% below regulated rates charged by generators in neighboring countries. Generators explained that these rates covered only their variable costs and characterized the GoA's below-market pricing formulas as broadly populist, inefficient (insofar as they subsidize users who can afford to pay more) and as "indirect expropriation" of generator investments. Further, they noted that the GoA's regulated wholesaler CAMMESA has only made payments to them for spot electricity sales through July.

¶5. (SBU) Electricity distributor AES noted that it was only partially allowed to implement industrial and wholesale end-user tariff rate increases negotiated with the GoA and that a full tariff review for one of its distributors promised by the GoA in 2006 had been delayed until after October 2007 elections as a matter of "political expediency." Gas transportation company CMS called favorable an ICSID ruling directing the GoA to pay it $130 million in compensation for contractual breaches in CMS' investment in one of the national gas pipelines. However, CMS complained that the GoA's ongoing diversion of gas supplies to the domestic market had forced it to default on contacted natural gas sales to Chile. Gas distribution company E-On complained that retail gas tariffs it is able to charge Argentine end consumers are roughly 10 times lower than rates normally charged in Brazil and Chile and argued that the GoA was "not respecting the contractual rules of the game" by failing to approve the pass through of increased costs to consumers.

¶6. (SBU) All participants agreed that independent electricity and gas regulatory authorities established during Argentina's 1990s privatization process had long since been subordinated to the post-crisis political process and were no longer independent. They saw little in the way of long term vision in the GoA's energy policy mix, but rather a short term focus on maintaining below market consumer prices in this pre-election year. They doubted that the GoA would - as it has promised - move to a substantially less regulated electricity and gas pricing model by 2008. Finally, participants argued that, while they could adapt their operating and investment strategies to a suboptimal but stable policy mix, the GoA's penchant for changing the rules of the energy sector game preemptively and without consultation made it difficult for them to justify to their Boards of Directors investments in expanded capacity that the Argentine market needs.

¶7. (SBU) Ambassador noted that Planning Minister De Vido had earlier offered to co-host sector-specific roundtables with the Ambassador to address U.S. investor concerns. Participants agreed that such a roundtable would offer a forum for the GoA to address broad regulatory inconsistencies and asked the Ambassador to request a

meeting in January.

Argentina's Electricity Sector

¶8. (SBU) Argentina has the third-largest power market in Latin America, relying mostly on hydropower and natural gas-fired thermal plants for most of its electricity supply. With approximately 28 gigawatts of installed generation capacity, 61% of Argentina's electricity production capacity is fossil fuel-based (primarily natural gas) and 35% is hydroelectric. Subsidized domestic demand has raised generating capacity utilization to internationally accepted limits, and experts are projecting power shortages this austral summer.

¶9. (SBU) Following the 2001/2002 economic crisis, the GoA pessified capacity payments to generators, reducing them to roughly 40% of their earlier dollar value, and changed the structure of electricity spot pricing so as to make investments in generation, particularly in marginal capacity, much less attractive. These interventions resulted in an electricity sector pricing mechanism for the wholesale generation market that provides few incentives for new greenfield investment. Private electricity sector players charge that, over the last four years, the GoA has undermined the electricity sector by freezing energy prices, manipulating the methodology used to set market prices, and effectively confiscating funds owed to private companies. The GoA has committed to "normalize" electricity sector tariffs by 2008.

¶10. (SBU) FONINVENMEM (Fondo de Inversiones en Mercado Electrico Mayorista:) With voluntary private investment in new electricity generating capacity limited by GoA price controls and investor concerns over rapid GoA shifts in sector regulation, the GoA created a fiduciary fund, FONINVENMEM, to "encourage" new investment in two new 800 MW combined cycle plants in Buenos Aires and Santa Fe provinces. The plants will cost $1.2 billion, of which $450 million is being funded by the swap of outstanding CAMMESA (the GoA's regulated electricity wholesaler) debt to generators into FONIMVENMEM equity. The GoA has stated that the remaining $750 million will be funded via a 3-4% surcharge on medium and large electricity users over the next 5 years, via private pension fund financing and via new investors.

¶11. (SBU) Generators' share of FONINVENMEM investment is roughly based on their share of domestic generating capacity, though the GoA's participation formula favors both higher margin hydroelectric producers and those generators who sell onto the spot market rather than through long term supply contracts. Of U.S. generation players, AES holds 20% and Duke 5%. France's Total (which announced the sale of its Argentine generating assets to a local group and to Merrill Lynch) holds 28%, Spain's Endessa 23%, and Petrobras 10%. In exchange for this investment, the GoA has committed to (1) have the GoA's regulated wholesale distributor, CAMESA, sign a power purchase agreement to guaranty the profitability of the two new plants; (2) secure dedicated gas supplies for the new plants; and (3) eventually transition to a free market in energy after the two new plants are on line.

¶12. (SBU) Electricity Generators Collections from CAMMESA: U.S. electricity generators project continued difficulty collecting full payment from the GoA/CAMMESA for 2007 power sales. These concerns are based on the growing CAMMESA deficit due to the mismatch between regulated prices and power production costs. According to a report prepared by CAMMESA, a cash deficit of about US$ 580 million is expected for the November 2006 - March 2007 period. As of November 2006, only payments owed for July 2006 had been paid in full, leaving August, September and October unpaid.

¶13. (SBU) ICSID Arbitration Claims: Numerous electricity sector players in Argentina have filed ICSID claims seeking compensation for some combination of (1) the GoA's pre-crisis de-linking of power tariffs from the U.S. PPI; and (2) post-emergency law pesification of generation capacity cost and variable cost payments by regulated wholesaler CAMMESA. Pre-crisis capacity payments to generators were

roughly US$10 /MW while current payments total ARP 12/MW.

AES: Electricity Generation and Distribution

¶14. (U) With over $1 billion invested since 1993 and over 1,600 employees, AES operates 6 hydro and gas-fired power plants in Salta, San Juan, Neuquin and Buenos Aires provinces with the capacity to produce 2.8 GW, 12% of Argentina's total installed capacity. AES is the third largest private generator, behind ENDESA (Spain) and TotalFina/Elf (France). AES also owns three distribution companies, EDELAP, EDEN and EDES, all in the province of Buenos Aires that provide energy to more than 750,000 customers.

¶15. (SBU) AES holds a $60 million in the two new FONIMVENMEM generation plants. AES filed an ICSID claim in 2002 seeking compensation for the GoA's post-emergency law pesification of capacity and variable cost payments to generators and the pesification and freezing of end-user electricity fees paid to distributors. In August 2005, AES agreed to suspend this ICSID suit in exchange for a GoA promise to permit a tariff increases in distributor AES' EDELAP electricity rates for rural industrial and commercial (but not politically sensitive residential) clients and to follow-on with a February 2006 full renegotiation of EDELAP's rate base. According to AES country manager Dutrey, the GoA ultimately allowed only a partial implementation of this agreed rate increase and the promised February 2006 rate base renegotiation was postponed until after October 2007 elections.

CMS: Electricity Generation & Gas Pipelines

¶16. (U) CMS entered the Argentine market in 1993 in electricity generation, gas transportation and trading services. Its assets include three power plants totaling 2000 MW installed capacity, CMS Ensneada, Centrales Termicas Mendoza and Hidroelectrica El Chocon, as well as stakes in three gas pipelines, Transportadora de Gas del Norte (TGN) , Transportador de Gas del Mercosur and the Atacama gas pipeline from Salta province to Chile.

¶17. (SBU) In July 2001, CMS filed an ICSID case regarding its investment in TGN, one of the two privatized Argentine gas transportation companies, charging that the GoA violated US BIT obligations via its unilateral modification of the legal and regulatory framework governing TGN including the pre-crisis de-linking of gas tariffs from the U.S. PPI and the post-emergency law pesification and freezing of natural gas pipeline tariffs. In May 2005, an ICSID tribunal found in favor of CMS and awarded the company damages of approximately US$ 150 million. This was the first final award issued of the xx claims pending. The GoA has filed an appeal to nullify the ruling and the Foreign Ministry has since publicly pledged to respect final ICSID rulings after the appeals process has been completed.

Duke Energy: Electricity Generation

¶18. (SBU) Duke Argentina owns two power generating assets are located in Neuquen province: The Planicie Banderita hydroelectric power station produces 479 MW and the Alto Valle gas-fired thermal station produces 80 MW. Duke also conducts licensed trading and marketing in the wholesale electric and natural gas markets as of late 2000.

¶19. (SBU) In discussions with the GoA, Duke has committed to upgrade its Alto Valle gas-fired plant to bring 17 MW of unused capacity on line. In return, Duke has asked the GoA to lock-in scarce natural gas supplies for this plant. Duke has also submitted plans to invest roughly $60 million to add 40MW of new generating turbines to its Neuquen hydro plant if an appropriate package of federal and provincial tax incentives can be negotiated.

Eton Park: Electricity Transmission

¶20. (SBU) Eton Park, a U.S. investment firm managing over US$5.5 billion, signed in August 2006 a contract with Brazil's Petrobras Energia Argentina to purchase its 50% stake in Citilec SA, the company that holds a 52.7% majority share in Argentine power transporter Transener. Petrobras's earlier takeover of independent Argentine energy group Perez Companc in 2003 was subject by GoA anti-trust authorities to Petrobras's sale of Perez Companc's stake in Transener. Transener is the largest electrical power transmission company in Argentina. The formerly state-owned company was privatized in 1993 with a 95 year concession and is considered to be one of the leading players internationally in long-distance power transmission. It owns the national high-voltage transmission network, with over 8,800 kilometers of transmission lines, as well as the 5,500 kilometer network of its controlled subsidiary Transba. In addition, Transener's Brazilian division separately operates over 2,300 kilometers of 500kV lines. Transener's combined networks are one of the longest 500kV systems in the world, as well as extensive 125kV and 250kV lines. Eton Park's purchase is not yet finalized.

E-On U.S.: Gas Distribution

¶21. (SBU) E-On US, a U.S. subsidiary of Germany leading energy provider, acquired LG&E Energy in 2001. Through this purchase, E-On now owns interests in three Argentine gas distribution companies: Distribuidora de Gas del Centro S.A.; Distribuidora de Gas Cuyana S.A.; and Gas Natural BAN S.A. These three gas distribution companies in which E.ON US has interests provide 33% of the natural gas consumed in Argentina, reaching a customer base of over 2.2 million.

¶22. (SBU) In late 2001, LG&E filed an ICSID suit against the GoA's pre-crisis de-linking of gas tariffs from the U.S. PPI and later amended the case to include the GoA's post-crisis pesification and freezing of these same tariffs. In an October 3, 2006, ruling, an ICSID tribunal did hold that the GoA violated provisions of the US BIT. However, at the same time, the tribunal exempted the GoA from liability for a 17 month December 1 2001 to April 26, 2003 emergency "state of necessity" period of the Duhalde presidency. While damages have yet to be calculated by the tribunal, the precedent this ruling sets is troubling to many ICSID claimants.

Comment

¶23. (SBU) That U.S. electricity and gas sector players see little in the way of long term vision in the GoA's energy policy mix is consistent with views expressed earlier by U.S. upstream and downstream hydrocarbon players (Ref A). Their doubt that the GoA will keep its promise to move a substantially less regulated electricity and gas pricing model by 2008 is troubling given the manifest need to expand domestic generating capacity to meet burgeoning demand. While the potential for ongoing energy shortages and blackouts during the peak summer season has been a media staple for some time, most analysts believe the GoA will be able to muddle through -- perhaps with some rationing -- until October 2007 elections. But the reluctance of electricity sector players to invest in new capacity in the face of the GoA's heavy handed energy policy mix will eventually force the GoA to consider reforms. The question is when and the only certainty is that substantive reforms will not be implemented before October 2007 elections.

WAYNE